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CAMEL Management System : Low Cost High Quality Approach and Corporate Financial Management

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journal or publication title	Bulletin of Saitama Gakuen University. Faculty of Management
volume	5
page range	79-86
year	2005-12-01
URL	http://id.nii.ac.jp/1354/00000937/



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企業においては「経営の健全性」(Sound Management)が絶えず問われるが、特に、財務管理に関しては、情報の開示ということからも財務の健全さが重要となる。その第一が「資金調達」であり、それには“CAMEL管理体系”を通した負債勘定による資産勘定のコントロール、つまり調達した資金の運用状況を示した資産勘定のコントロールが重要である。また、銀行の環境変化は企業経営に関しても大きく影響を与え、それは企業による「自己資本の充実」ということが強く要求されることである。もちろん、企業の投資効率を高めるためにも自己資本の充実は重要であり、また「収益性の確保(向上)」を考えるにあたっては、Low Cost High Qualityの考え方の導入は不可欠である。そして、同時に、Maximum Benefit in the Minimum Timeという時間価値の概念も併せて持つことが重要である。

(注) CAMELとは、Capital, Assets, Management, Equity (Earnings), Liquidity (Liabilities)の略である。「C」資本、「A」資産、「M」管理運営、「E」利益、「L」流動性及び負債、の以上5項目に関する財務管理である。

### . Introduction

This paper addresses the future of corporate financial management by Japanese companies, as it relates in general to the new era of Japanese-style business practices. The author

has been employed for 15 years in international operations at foreign banks, and here considers corporate financial management as an important aspect within the context of a Japanese-style business management system that is in need of reform. In particular, this pa-

キーワード : CAMELマネジメント、生産性、財務管理、経営の健全性

Key words : CAMEL Management, low cost high quality approach, financial management sound management

per discusses the future of corporate financial management as it relates to the establishment of a general management approach that is more focused on profitability.

Japan became recognized as a leading economy only after 1970, and is a newcomer when considered against long-term economic powers such as the US and the advanced economies of Europe. At the same time, Japan's ability to maintain a strong economy for over 20 years has attracted considerable attention and even the strong economy has been envied from countries throughout the world.

This worldwide recognition also apparently extends to the "Japanese style of management," which has been acclaimed for its ability to maintain efficiency, productivity, flexibility, and stability. But the bursting of the financial bubble in 1990 has tarnished this picture, and the system that powered Japan's strong growth period<sup>(1)</sup> is in need of reform. The well known Japanese employment system – with that's lifetime employment and seniority system – achieved great success by reaping the benefits of "cooperation." However, this system could be maintained only under conditions of continuous business expansion, and will not be sustainable under the lower growth rates projected for the future.

Businesses are, therefore, being pressed to establish more efficient and profit-oriented management. This in turn entails a reform of financial management<sup>(2)</sup> practices. Specifically, management functions<sup>(3)</sup> must be systematically applied to finance activities with the aim of improving profitability and maintaining

liquidity. The reforms necessary to ensure the health of Japanese businesses in the new era have therefore become an important focus of attention.

### . The Trend of Foreign Financial Institutions

One indication of a country's financial power is the number of foreign financial institutions that have established offices there. All G7 countries, as well as Switzerland, are home to major international financial cities.<sup>(4)</sup> Among this group, Tokyo is now recognized as one of the top three international financial markets, together with New York and London. Many foreign institutions maintain Tokyo branches or representative offices. In particular, figures show that foreign banks and securities companies moved strongly into Tokyo after 1970, when Japan initially gained recognition as a leading economic power. This concentrated and rapid inflow of foreign financial concerns is the reason that Tokyo has quickly risen to become one of the three top centers of international finance. It is significant that this rapid entry into Japan came at the same time that Japan was experiencing strong economic growth. Specifically, the rapid influx of foreign financial institutions<sup>(5)</sup> coincided with rapid growth in the Japanese GNP. Since 1990, when the Japanese financial bubble burst, many of foreign banks and securities have elected to withdraw from Japan. It is again noteworthy that their withdrawal coincides with a drop in Japanese GNP growth. There would appear to be a positive correla-

tion between the Japan's economic development, on the one hand, and the movement of foreign financial institutions into and out of Japan, on the other.

The excessive plant-and-equipment investment that characterized the bubble period weighs heavily on the economy and had significantly reduced economic growth. It is generally believed that it will take some years for the economy to absorb the excess capacity and return to a healthy state.

Foreign financial institutions therefore perceive that Japan is facing a prolonged period of sluggish growth. At the same time, wages and prices within Japan remain high by world standards. Foreign institutions tend to place strong emphasis on profitability, and are aware that prospects within Japan may be limited. It would appear that those companies that have left Japan are precisely those that are most concerned with maintaining profitability.

The future of corporate financial management by Japanese firms must be influenced by the tendencies of foreign institutions. In particular, foreign management is characterized not only by an emphasis on profitability, as mentioned above, but also by the tendency to maintain sufficient levels of equity capital. These two tendencies have important implications for the future of business and financial management in Japan.

## . Credit Creation and Corporate Financial Management

### • Credit Creation

Businesses appeared to be exercising activist, intelligent management during the bubble period of the late 80s, but the collapse of the bubble in early 1990 called management principles into question. There was a widespread feeling that basic changes were required in Japanese-style employment and investment systems, even though these had seemed major advantages just a short time before.

Let us briefly consider the bubble economy that has so shaken the roots of the Japanese style of management. The term bubble refers to creation of excess, unsubstantiated credit; to the creation of excess deposits (money). In essence, lending institutions lend out many times more money than they receive in initial (base) deposits. During the bubble period, companies found that they could obtain new capital at low cost by borrowing at low rates from banks (the prime rate was 2.5% in February 1987), then issuing euro-dollar denominated warrant bonds<sup>(6)</sup> on the London Euro-market (taking advantage of the rising Japanese stock market), then swapping<sup>(7)</sup> the dollars obtained from the bond sales back into yen.

In general, the bulk of the huge assets acquired through equity financing<sup>(8)</sup> in the latter half of the 80s was being invested back into the stock and real-estate markets by means of special cash trusts<sup>(9)</sup> and fund trusts.<sup>(10)</sup> This cycle continued to funnel funds into the stock

market. At the same time, the speculation-driven rise in the price of land gave general companies an increased ability to obtain mortgage financing. Banks competed heavily to loan money under these conditions; credit was easy, and the expansion of baseless assets continued until the cycle collapsed in early 1990.

#### • Funding and Financial Management

Funding, or capital procurement, is an essential aspect of business control. Capital, in this context, may be defined in various ways – for as example, as cash and deposits, or as net working capital (the difference between liquid assets and liquid liabilities). In today's monetary economy, capital is the essential requirement for all business activity. In order to fulfill its function, capital must represent a reliable means of payment; its value as a medium of exchange must be grounded in economic reality. During the bubble period, capital lost its grounding. The rise in securities prices, the appreciation in real-estate valuations, and borrowing from banks (often at the behest of the banks themselves, which urged companies to open deposit accounts from which they could borrow) generated asset inflation. This inflation made it difficult to exercise sound financial management.

Financial management involves two different types of activity: financial planning and control on the one hand, and funding and fund utilization on the other. Typically, management is handled by two different divisions: the Dealing Division (which attempts to make

a profit through transaction and lending activities) and the Operating Division (which handles administration and control, and is not profit-oriented).

Consider that one of the management objectives of a corporation is to maximize profit. Firms that are engaged in commercial activities must determine how to utilize funds so as to meet this goal. These firms, of course, must first meet the problem of procuring the funds they need to use. Below, I want to discuss the issue of funding in more detail.

The bursting of the bubble has brought about a change in the funding approach used by business concerns. In particular, the precipitous drop in the Tokyo stock market, which peaked in late 1989 and was moving down by early 1990, has had a significant affect on funding methods, and has made it difficult to procure funds under advantageous conditions. One reason for this difficulty is the reduction in equity financing. Another reason is that banks have been forced to become more circumspect in issuing loans. Before the bursting of the bubble, Japanese banks were not overly concerned with working off bad loans, and were often willing to extend credit to non-creditworthy concerns. With the drop in share prices and real-estate values, banks no longer have this luxury<sup>(1)</sup> and have been forced to become more selective. Companies therefore are having trouble raising funds. A particular problem is that companies have not yet adapted to the change that banks have made in response to the new environment.

## . Liabilities Accounts and Equity Capital

We can expect that liabilities will become an increasingly important item of the balance sheet as corporate financial management adapts itself to new realities. Under the bubble economy, companies built up the assets side of the balance sheet as a means of increasing profits. This process generated losses for many firms – for banks as well as for borrowers. In future, companies will have to pay careful attention to their liabilities accounts as they carry out funding. In other words, asset accounts will be controlled in accordance with liability accounts. Emphasis will shift from the utilization of funds to the process of funding itself, and treasury departments will assume a central roll within the corporation. Asset accounts will need to be carefully controlled with respect to utilization of procured funds.

Companies, of course, are obliged to eventually pay their liabilities, and must use their procured funds to do this. *Equity capital* provides the backing required for meeting these obligations. Business risk must be quantified, and losses in asset value must be covered by equity capital.

Japanese financial institutions, and banks in particular, have traditionally adopted a management strategy that gives priority to expansion. The influence of BIS rules<sup>(12)</sup> in the first half of the 1980s; however, changed the picture, as Japanese banks came under pressure to increase their equity capital. Bank

management strategy, therefore, began to place greater weight on equity-capital sufficiency, and banks changed their lending approach from quantity (expansion) to quality (profits).

This change in banking management strategy has broad implications for businesses in the post-bubble economy. Businesses, like the banks before them, must now shift their emphasis to profits. And the fact that banks place more emphasis on equity capital means that businesses must do the same. In order to procure funds from banks, businesses need to maintain (or improve) profitability, and must maintain sufficient levels of equity capital.

It is worthwhile considering the four principal strategies that American banks have used to enhance profitability: (1) a general move toward concentration on specific areas of financial expertise (specialization); (2) downsizing of staff (restructuring); (3) improvement in quality of assets (through reduction in bad assets and bad debts); and (4) enhancement of equity capital. These four points have become the basis of American banking management and business strategy.

## . Low Cost High Quality and CAMEL Management

The above discussion has described how the bursting of the bubble has changed the financial management environment with regard to funding, debt, and equity capital. We now turn to the question of what business must do to reshape management and financial

operations so as to secure strong profitability.

In particular, we discuss various themes related to business management functions in the post-bubble economy.

In order to enhance earnings in a consistent way, it is necessary to monitor the state of operations and to implement continuous improvements. The Japanese word for “improvement” is *kaizen*, and the philosophy of implementing continuous improvement has become known as the *kaizen* system, or as *kaizenning*. The concept has been already gained worldwide attention. Masaaki Imai defines the term to mean “gradual, unending improvement; doing ‘little things’ better; setting—and achieving—every higher standards” (*Kaizen*, McGraw-Hill Publishing).

Business concerns are moving to implement this kind of improvement through operational and organizational reform: specifically, by improving productivity, efficiency, and quality not only in production processes but through their entire range of business operations. In order to enhance profitability, businesses need to implement efficiency-based earnings management. To put this another way, firms need to implement management activities that are focused on the goal of profitability. In order to achieve this, companies will need to establish management systems that take into account profitability and management with respect to the company’s finances and financial affairs.

#### • Low Cost High Quality

Accordingly, businesses will need to focus

on a “Low Cost High Quality”<sup>(13)</sup> approach. Profit-based management focused on low-cost and high-quality is essential not only for general management but also in the area of financial management. Business management is also under pressure to achieve operational speed and operational precision. The applicable concept here is “Maximum Benefit in the Minimum Time.” This concept adds the idea of time value into the “low cost, high quality” equation, and stresses the idea of the pursuit of “benefit.” The term “benefit” here refers not only to the company’s bottom-line profit but also to the financial returns and non-financial benefits that accrue to the company’s employees.

#### • CAMEL Management System

Another conceptual approach that must be implemented is known by the acronym “CAMEL”: Capital, Assets, Management, Equity (Earnings), and Liquidity (Liabilities). Adequate risk control in relation to each of these items is essential for sound financial management. The Japanese Ministry of Finance specifically looks at each one of these five items when investigating banks.

As business management is forced to place every greater emphasis on profits, the CAMEL approach will serve as an important check function from the financial-management side. This will help lead to a low-cost high-quality result with secure profit levels.

## . Conclusion: Corporate Sound Management

Businesses in the post-bubble era will be required to maintain sound management at all times. Financial management will also need to be sound, not least because of need for disclosure.

Funding is the most significant aspect of sound financial management. Management will need to utilize the “CAMEL” Management System approach so as to control assets accounts with respect to liability accounts; i.e., such that assets accounts indicate the utilization of procured funds. The changes that have occurred in the banking environment shall have a strong influence on general business management. In particular, businesses will need to maintain adequate levels of equity capital. It should be noted that adequate equity capital is also essential from the aspect of promoting investment efficiency.

Finally, companies will need to implement a “Low Cost High Quality” approach in order to maintain or increase their profitability. This will need to be combined with a “Maximum Benefit in the Minimum Time” philosophy. In order to maintain “Sound Management”, business managers will need to keep these considerations in mind at all times. Corporate financial management will also need to give attention to these considerations.

## Notes

(1) The Japanese economy of the late 1980s was

characterized by a speculative bubble in the areas of real-estate and stock investments, fueled by low interest rates and easy credit conditions. The bubble economy impacted significantly on the “real” economy; the bursting of the bubble in 1990 inevitably led to a protracted period of low and at times negative corporate growth.

- (2) “*financial management*” refers comprehensively to financial planning, financial control, funding, and fund utilization.
- (3) “*management functions*” refers to tasks that must be carried out by management and organizations.
- (4) The seven advanced economies are: Canada, the USA, the U.K., France, Germany, Italy, and Japan. The major financial cities, by region, are: Toronto, Chicago, and New York, (in North America); Tokyo, Hong Kong, Singapore, Sydney (in Asia/Oceania), and London, Paris, Frankfurt, Zurich, and Milan (in Europe).
- (5) At the end of July 1992, 95 foreign banks (including 9 trust banks) and 48 foreign securities firms had opened branches in Japan. More than half of the bank branches, and every one of the securities branches, had entered Japan after January 1, 1970. According to 1992 economic accounts put out by the Economic Planning Agency, GNP growth between 1970 to 1980 (170.2 trillion yen) was almost triple the growth between 1960 to 1970 (58.5 trillion yen), suggesting that rapid GNP growth in the decade of the 70s coincided with entry of foreign financial institutions (in particular, foreign banks and securities companies).
- (6) A *warrant* is the right to purchase new-issue shares at some predetermined price.
- (7) The term *swap* here refers to exchange of debt obligations across currencies.
- (8) *Equity financing* : Acquisition of capital through issuing of new securities, such as stocks, bonds, and warrants.
- (9) *Special cash trust* : a cash trust set up for a



specified purpose, to be operated in accordance with specified rules. Special cash trusts set up for the purpose of stock-market investment offer a tax advantage in that gains can be converted into dividends (so that capital gains tax can be avoided).

- (10) *Fund trust* : Cash trust (other than “money trust”) that can be operated independently for arbitrary investment purposes.
- (11) Total bad debt for city banks, long-term credit banks, and trust banks, as of September 1993 (semi-annual settlement), was 13,750 billion yen.
- (12) *BIS rules*: Regulations for general banks, promulgated by the Bank for International Settlements (BIS). Under these regulations, banks with high levels of asset risk are required to maintain higher levels of equity capital.
- (13) The “*low-cost, high quality*” approach includes the concept of “relationship investing,” in which shareholders maintain close relationship with management, and provide advice to management aimed at improving business results and elevating the stock price. This relationship is in contrast to the traditional shareholder/manager relationship, in which contact is limited to once-a-year adversarial meetings.

When considered broadly, the “low-cost high quality” concept also includes the idea of “re-engineering”: making maximum use of information to assess and fundamentally redesign the business process.

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